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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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In the Matter of	)	
	)	
Price Caps Performance Review for Local Exchange Carriers	)	**CC Docket No. 94-1**
	)	

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REPLY COMMENTS OF
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TABLE OF CONTENTS

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REPLY COMMENTS
OF THE CALIFORNIA CABLE TELEVISION ASSOCIATION

The California Cable Television Association ("CCTA") hereby submits its reply comments on the Fourth Further Notice of Proposed Rulemaking ("Fourth NPRM") in the above-captioned proceeding. CCTA is a trade association representing cable television operators with over 400 cable television systems in California, including both small rural systems and national multiple system operators. CCTA's members are potential facilities-based competitors of local telephone companies in the provision of video services and local exchange telephone services to the public in California.[1/]

INTRODUCTION AND SUMMARY

Less than one year ago, the Federal Communications Commission ("FCC" or "Commission") adopted the First Report and Order in its price cap performance review docket, in which it undertook a comprehensive review of the Local Exchange Carrier

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[1/] CCTA has participated actively in the Commission's price caps docket, filing comments and reply comments in the Commission's Notice of Proposed Rulemaking and the Second Further Notice of Proposed Rulemaking. See, e.g., Comments of CCTA, CC Docket No. 94-1, filed May 9, 1994; Reply Comments of CCTA filed June 29, 1994; comments of CCTA in the Second Further Notice, December 11, 1995.

("LEC") price cap plan over the previous four years.[2] At that time, the Commission concluded that the data on which it had originally set the productivity offset ("X-Factor") contained an error that, when corrected, justified a higher X-Factor.[3] The Commission also created three X-Factor options, ranging from 4.0% to 5.3% (with diminishing sharing requirements), to "encourage [the LECs] to continue to increase their rate of efficiency growth ...."[4] At the same time, the Commission articulated its intent to explore long-term issues regarding recalculation of the X-Factor options and the efficacy of the sharing mechanism.[5] In response to the FCC's Order, several LECs, including the major California LECs, Pacific Bell and the GTE Service Corporation and affiliated domestic telephone operating companies ("GTE"), have selected the 5.3% X-Factor, which entails no sharing.[6]

The top item in the LECs' wish list submitted in response to the Fourth NPRM is a substantial reduction in the X-Factors that the Commission adopted in the First Report and

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[2] Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, First Report and Order, 10 FCC Rcd 8961 (1995) ("First Report and Order"); see also Price Cap Regulation of Local Exchange Carriers, Rate-of-Return Sharing and Lower Formula Adjustment, CC Docket No. 93-179, Report and Order, 10 FCC Rcd 5656 (1995) ("Rate-of-Return Sharing Order").

[3] First Report and Order, 10 FCC Rcd at 8970-71.

[4] Id., 10 FCC Rcd at 8970-71.

[5] Id., 10 FCC Rcd. at 8968-71.

[6] Price Cap Performance Review for Local Exchange Carriers, Fourth Further Notice of Proposed Rulemaking, CC Docket No. 94-1, at ¶¶ 7, 8, n.17 (rel. Sept. 27, 1995) ("Fourth NPRM").

Order.[7] Thus, the United States Telephone Association ("USTA") advocates that the X-Factor be reset using a five-year rolling average of the difference between LEC Total Factor Productivity ("TFP") and TFP for the United States economy as a whole.[8] USTA further recommends that the X-Factor be calculated using a "simplified" TFP methodology developed by its consultants, Christensen and Associates.[9] The effect of this recommendation would be an immediate reduction in the X-Factor from the current range of 4.0% to 5.3% to a mere 2.78%, the TFP differential that Christensen and Associates calculate for the period 1990-1994.[10] As a result, for LECs, including Pacific Bell and GTE, that have elected the Commission's highest X-Factor, the required productivity offset would be immediately slashed by nearly 48%.

Statements by the LECs, however, are wholly contrary to such a conclusion. In direct contradiction to its call for a decreased productivity factor, Pacific Bell has repeatedly stated that its investment in a hybrid fiber-coaxial cable ("HFC") architecture will result in significant efficiencies and savings in telephony operational costs.[11] Despite these

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[7] See, e.g., Comments of Pacific Bell and Nevada Bell at 1-2 ("Pacific Bell Comments"), GTE Comments at 6-8 ("GTE Comments"), USTA Comments at 3, Southwestern Bell Telephone Comments at 3-6 ("SWBT Comments").

[8] USTA Comments at 4, 34-37.

[9] Id. at 4, 37.

[10] See id. at 3.

[11] Applications of Pacific Bell for Authority Pursuant to Section 214 of the Communications Act, as Amended, to Construct, Operate, Own, and Maintain Advanced Fiber Optic Facilities and Equipment to Provide Video Dialtone Service to Selected Communities in Orange County, the Southern San Francisco Bay area, the Los Angeles area, and the San Diego area in California, File Nos. W-P-C 6913-6916, Order and Authorization,
(continued...)

representations, Pacific Bell now urges the Commission to find they will be less, rather than more, efficient despite the fact that nothing in the record or the economics of the industry justifies the suggested changes to the X-Factor.[12/] In particular, neither the LECs' assertions that competition will prevent them from continuing to achieve past levels of productivity growth nor the quantitative evidence regarding the expected level of productivity growth, and the input price differential, supports a reduction in the X-Factors that the Commission adopted less than one year ago and which were held to advance "the public interest goals of just and reasonable rates."[13/] Accordingly, CCTA urges the Commission to reject the proposed TFP methodology as contrary to the public interest.

Moreover, given the sweeping changes that will be implemented in light of the passage of the Telecommunications Act of 1996 ("1996 Act"),[14/] CCTA asserts that the Commission would be ill-advised to make fundamental changes to its price caps structure at this time. First, there is a clear interplay between the overarching issues and policies in the instant Fourth NPRM and those that the FCC must implement under the 1996 Act, so that common sense and sound policymaking dictate that the FCC wait until it can assess as a whole the impact of its actions. Second, given the enormous burden that implementation of

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[11/](...continued)
at ¶ 50 (citing Testimony of Pacific Witness Robert G. Harris, Exhibit 3 at 8 (filed Dec. 20, 1993). While CCTA has vehemently disputed these assertions, at a minimum, Pacific should not be permitted to have it both ways. See Section I.B., infra.

[12/] Pacific Bell Comments at 1, 3, 6.

[13/] Price Cap Performance Review for Local Exchange Carriers, CC Docket 94-1, Order, 10 FCC Rcd 11991, 11999 (1995).

[14/] Pub. L. No. 104-104, 110 Stat. 56 (1996).

the 1996 Act places upon the Commission, the FCC should concentrate its limited resources on promoting actual facilities-based competition rather than amending the price caps scheme based upon speculative LEC assumptions about future competition. After all, the LECs have a vested interest not only in making rosy assumptions about competition, but also in preventing those rosy assumptions -- particularly with respect to facilities-based competition -- from coming to fruition.

Finally, CCTA continues to assert that regardless of whatever methodology is needed to set price cap rates, including TFP, the use of price caps alone will not ensure that rates are driven to their true economic costs or protect fully against improper anticompetitive behavior such as cross-subsidization. As the LECs undertake substantial infrastructure investments that can be used to offer new services such as video (including cable television or open video services[15/]), there remains a bedrock issue regarding the proper allocation of common costs that affects incentives for improper conduct. The resolution of this issue will, in turn, affect price cap rates. Consequently, CCTA continues to urge that the only way for the Commission to fulfill its mandate of ensuring just and reasonable rates is to undertake a thorough examination of costs in light of cost causation principles.

[15/] Under the 1996 Act, a telecommunication carrier may provide video programming through an "open video system" certified by the FCC to be offering non-discriminatory capacity for unaffiliated programmers, subject to selected provisions of the Cable Act. See 1996 Act § 653, as enacted by Pub. L. No. 104-104, § 302(a), 110 Stat. 56 (1996).

ARGUMENT

I. NEITHER THE LEVEL OF COMPETITION NOR THE EVIDENCE REGARDING TOTAL FACTOR PRODUCTIVITY JUSTIFIES A REDUCTION IN THE PRODUCTIVITY OFFSET

A. Competition Will Not Preclude the LECs from Maintaining Past Levels of Productivity Growth

A constant refrain in the LECs' opening comments is the complaint that increased competition will preclude them from achieving the same levels of productivity growth that they have hitherto achieved under price caps.[16/] This unsupported assertion presumes that the level of competition will be sufficient to reduce the LECs' output substantially — a highly implausible assumption, at least in the near term. Moreover, the argument wholly ignores the opportunities that the LECs will have to offset any output-reducing effects of heightened competition by downsizing to provide the new, lower level of output more efficiently and by offering new products and services.

Contrary to what the LECs would have the Commission believe, the type of facilities-based competition that the LECs posit is neither pervasive today nor will it become so overnight.[17/] Although the 1996 Act removed legal barriers that prohibited local exchange competition in most states,[18/] it did not create flourishing facilities-based competition

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[16/] See, e.g., Pacific Bell Comments at 1.

[17/] As CCTA has stated in comments on the Commission's Second Further Notice of Proposed Rulemaking, CC Docket 94-1, only facilities-based competition can produce the benefits the Commission seeks to achieve. Before such competition can become a reality, however, there are numerous competitive benchmarks and criteria that must be achieved. See CCTA Comments at 8-10 (filed Dec. 11, 1995) ("CCTA Second FNPRM Comments").

[18/] See, e.g., 47 U.S.C. §§ 251-253, 256-260, enacted by Pub. L. No. 104-104, § 101, 110 Stat. 56 (1996).

overnight. Indeed, as this Commission well knows, the herculean task of developing regulations to implement the 1996 Act alone will take considerable time and resources. The Commission has tentatively scheduled the critical interconnection rulemaking to be issued in April and to be completed in August 1996.[19] This is only one, albeit a very important one, of the dozens of rulemakings that will be needed to implement the 1996 Act. Furthermore, once the rules are in place, it will take more time for new entrants to become operational and to market their services to significant numbers of customers, assuming the process goes smoothly.

Critically, even in states such as California where the California Public Utilities Commission ("CPUC") embarked upon the process of developing local competition rules prior to the passage of the 1996 Act, the pace of competitive inroads into the LECs' output and revenues has been slow. Although implementation of the 1996 Act may eventually eliminate some of the problems that have slowed the pace of local exchange competition, other barriers will remain untouched. Today, only the incumbent LECs have ubiquitous networks capable of providing facilities-based service to the entire customer base. New entrants need time and considerable capital to build out networks to offer competitive local exchange service.[20] Thus, while nominally, there are some 62 Competitive Local Carriers ("CLCs") certificated to provide local exchange services in various parts of California as of

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[19] Common Carrier Bureau Public Forum on Implementing The Telecommunications Act of 1996, Implementation Schedule at 3 (Feb. 23, 1996).

[20] In the meantime, new entrants will rely heavily on resold LEC services, which will help to maintain the LECs' output and revenues even in the face of "competition."

February 23, 1996,[21] in actuality, only one of the newly certificated carriers is now in a position to market its services actively. The "new entrant" is Pacific Bell, which is now aggressively marketing its local exchange services in the areas around Los Angeles previously served only be GTE California, Inc.[22]

In fact, after more than a year of negotiations with the incumbent LECs and litigation before the CPUC,[23] CLCs are still awaiting decisions regarding rates for interim local number portability and wholesale services. Moreover, the rates that the CPUC will soon adopt for these interim number portability and wholesale services are themselves interim in nature. The CPUC has scheduled a massive costing and pricing proceeding, which will extend through 1997, to set "permanent" rates for interim number portability, unbundled LEC services, and bundled LEC wholesale services.[24] Based on the current schedule, CLCs will not be able to obtain access to critical unbundled elements of the LECs' network, such as unbundled loops and ports, until January 1, 1997 or beyond.[25]

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[21] CPUC Decision 96-02-072, mimeo at 6 (issued Feb. 23, 1996).

[22] Furthermore, under the 1996 Act, GTE is permitted to offer a bundle of local, intraLATA and interLATA services, even before it meets the competitive checklist. <u>See</u> 47 U.S.C. §§ 251, 271, as enacted by Pub. L. No. 104-104, §§ 101, 151, 160(2); H.R. Conf. Rep. 458, 104th Cong., 2d Sess. 123 (1996) ("Conference Report"), 110 Stat. 56 (1996).

[23] <u>See</u> CPUC Decision 96-02-072, mimeo at 3-4 (issued Feb. 23, 1996).

[24] <u>See</u> <u>Administrative Law Judges' Ruling Setting Final Schedule for Review of Cost Studies and Pricing Hearings Thereon</u>, CPUC Docket R93-04-003/I.93-04-002 at Appendix A (issued Feb. 14, 1996).

[25] <u>Id.</u>; <u>see</u> <u>also</u> CPUC Decision 95-12-106 (issued Dec. 20, 1995). Even that schedule is in peril because Pacific Bell and GTE have failed to meet many of the deadlines for submitting cost studies to the CPUC and the parties, or have met the deadlines with such inadequately documented materials that there is little basis on which the CPUC could set rates.

Similarly, incumbent LECs also benefit from customer inertia and from "brand loyalty." With all these considerable advantages, there is little reason to expect the incumbent LECs to lose significant market share overnight to new entrants in the local exchange market. A decade after divesture, many consumers still believe they receive local phone service from AT&T.[26] Given the critical nature of what is at stake -- the public's interest in just and reasonable rates in this moment so that the promise of facilities-based competition expressed in the 1996 Act can be realized -- the Commission should act on clear evidence rather than general conjecture as to the levels of competition that will develop and what impact they will have.

Significantly, the LECs also will be able to offset the effects on productivity of such competition-induced reductions in output. As MCI correctly observes, even if competition does reduce the LECs' output (or, more likely, slow the rate of growth of the LECs' output), the LECs can and will respond by reducing the level of inputs that they purchase.[27] Moreover, the Commission should not ignore the fact that the LECs will have opportunities for revenue and output growth from new products and services. The most obvious example is the potential for expanded output as a result of entry into the interLATA toll markets. The 1996 Act allows the Regional Bell Operating Companies ("RBOCs") to enter out-of-region interLATA markets immediately.[28] It also enables GTE to enter in-region interLATA

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[26] See "Long-Distance Industry Plots Local Market Strategy," Washington Telecom News (Sept. 11, 1995).

[27] MCI Comments at 26.

[28] See 47 U.S.C. § 217(b)(2), as enacted by Pub. L. No. 104-104, § 151(a), 110 Stat. 56 (1996).

markets immediately[29] and grants the RBOCs the right to do so upon meeting certain criteria for enabling local competition.[30] Thus, either prior to or simultaneous with taking steps to remove barriers to competition, GTE and the RBOCs will be able to tap a hitherto unavailable source of output growth and revenue, which should increase their expected productivity growth. The introduction of other new products and services, stimulated by competition, will only add to this effect.

A recent proceeding at the CPUC on the productivity factor for intrastate price caps in California underscores the speculative nature of the LECs' claims about competition. Although the CPUC decision changed the intrastate California X-Factor from 5 percent to an amount equal to the annual Gross Domestic Product Price Index ("GDPPI") increase,[31] the California decision was based on nothing more than speculation about future competitive outcomes.[32] Contrary to the CPUC's decision, the presiding Administrative Law Judge Reed determined that there was no evidentiary basis for lowering the X-Factor in California.[33] Significantly, ALJ Reed considered much of the same evidence that the LECs have presented to the Commission in this docket, including the earlier version of the Christensen Associates study and the same sort of anecdotal and speculative "evidence" of

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[29] See id. at § 271; see also Pub. L. No. 104-104, § 601(2).

[30] Id. at §§ 271(b)(2), 271(c)(1)(2), 271(d)(3).

[31] See CPUC Decision 95-12-052 (issued Dec. 20, 1995).

[32] See Proposed Decision of Administrative Law Judge Jacqueline R. Reed in CPUC Investigation I.95-05-047 at 28 (mailed Nov. 20, 1995). A copy of this decision, in relevant part, is attached hereto.

[33] Id. at 55.

competition included with the LECs' filings here.[34] Given the serious and substantial debate over the legitimacy and sufficiency of the competitive assumptions in California, this Commission should act here in a deliberate and rational manner and avoid reducing the interstate X-Factor in anticipation of a level of competition that may never materialize.

The conclusion is straightforward. Not only have the LECs failed to provide any genuine evidence that increased competition will lead to decreases in their rate of productivity growth, but also the best available information suggests that the opposite, is in fact, the case. The opportunities granted to the LECs under the 1996 Act should enhance their output growth and, other things being equal, their rate of productivity growth. Therefore, if anything, the Commission should seriously consider increasing, rather than decreasing, the X-Factor in the price cap index.

B. The Quantitative Evidence Does Not Support the LECs' Conclusion that the Correct X-Factor is 2.78%

In its opening comments, USTA presents the results of the revised study by Christensen Associates purporting to show that the five-year average productivity offset (i.e., the difference between LEC and U.S. economy TFP growth) was 2.78% for the period 1990-1994.[35] Although the new simplified Christensen TFP study eliminates some of the problems of the prior study these consultants performed on behalf of USTA -- most notably

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[34] See id. at 9-11, 27.

[35] USTA Comments at 3.

by using publicly available data to a much greater extent[36/] -- it does not provide a reasonable projection of expected LEC productivity growth for at least three reasons.

First, like the prior study, the new Christensen study relies on data for the price cap LECs during a period in which those LECs had every incentive to keep reported levels of productivity low. Even though these companies operated under price caps at the federal level, the Christensen study is based upon "total company" TFP numbers that include both intrastate and interstate productivity performance and are in fact most heavily influenced by the intrastate numbers. In many states, the LECs operated under traditional rate-of-return regulation for some or all of this period, with all the productivity-sapping effects that such regulation entails.[37/] In other states including California, and at the federal level, the LECs operated under various alternative forms of regulation that included a sharing obligation, which is widely acknowledged to create many of the same disincentives for productivity

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[36/] The new Christensen study still uses some information that is LEC-proprietary and/or unaudited by external sources. For example, the "economic depreciation rates" that Christensen uses are not the same as the depreciation rates that this Commission has approved for the LECs. This introduces a needless source of controversy into a methodology that USTA recommends be used for an annual update of the X-Factor. CCTA agrees with the tentative conclusion that any long-term methodology that the Commission adopts should rely on externally verifiable data that is not subject to manipulation by the LECs. Fourth NPRM at ¶ 16. LEC-proposed depreciation rates, for example, clearly do not fit this criterion because they are set internally by the LECs and cannot be measured against objective external benchmarks.

[37/] These effects have been well documented and long-recognized by the Commission. See, e.g., First Report and Order, 10 FCC Rcd at 8973 (citing H. Averch and L. Johnson, Behavior of the Firm Under Regulatory Constraint, 52 Amer. Econ. Rev. 1052 (1962)).

growth as does traditional rate-of-return regulation.[38] To compound this problem, the LECs were highly aware during the 1990 to 1994 period that their achieved productivity performance would be a major determinant of the level of productivity offset determined by this Commission and several state regulatory commissions upon review of price cap plans. This gave the LECs an added incentive to keep some potential productivity improvements under wraps. Thus, on a going-forward basis, with more and more states adopting some form of price cap regulation and removing some services from price controls altogether, and with many states and this Commission eliminating sharing obligations for many price cap regulated carriers, future LEC productivity growth should exceed past performance.

Second, during the 1990 to 1994 period, the incumbent LECs had strong incentives to invest heavily in their networks in advance of actual demand for the services that new investment could provide. As CCTA has explained in prior comments in this docket,[39] as well as in its comments on Pacific Bell's § 214 applications for authority to provide video dialtone services,[40] the transition from rate-of-return or price caps-plus-sharing regulation to "pure" price caps has given the LECs good reason to advance their investments in upgraded infrastructure. By advancing the timing of new investment, the LECs were able to

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[38] Cf. USTA Comments at 39 (citing Robert G. Harris, "Economic Benefits of LEC Price Cap Reform," appended as Attachment 2 to USTA's Comments, CC Docket No. 94-1, May 9, 1994, pp. 20-21). See also Simplification of the Depreciation Presubscription Process, CC Docket 92-296, Report and Order, 8 FCC Rcd 8025, 8036 (1993).

[39] See, e.g., Price Cap Performance Review for Local Exchange Carriers; Treatment of Video Dialtone Service Under Price Cap Regulation, CC Docket No. 94-1, CCTA Comments at 13-14 (filed April 12, 1995).

[40] See, e.g., Ex Parte Letter from CCTA to Kathleen M.H. Wallman, Chief, Common Carrier Bureau at 9, of Jan. 6, 1995.

show lower earnings, thus obviating rate decreases under traditional regulation or sharing under price caps. The investment in new technology stands ready to enable the LECs to compete more effectively with new intraLATA toll and local exchange competitors, as well as to compete in the interLATA toll market with interexchange competitors and the video services market with cable and other competitors. For example, Pacific Bell has an extensive interLATA fiber-optic network that currently provides "official company services" but can easily form the backbone of an in-region interLATA network as soon as the company's entry into the interLATA market is approved.[41/] Like Pacific Bell, other LECs will be able to expand output at a relatively low incremental cost because they have substantial fiber-optic and digital switching capacity already in place from their investments in the 1990-1994 time period.[42/] Thus, it is quite probable that the LECs' achieved productivity in the early 1990s in fact understates the expected level of productivity growth for the remainder of the decade.

Moreover, the Commission need only refer to Pacific Bell's own testimony for a compelling account of the efficiencies that the LECs expect to achieve from these same infrastructure investments. Testifying in support of Pacific Bell's video dialtone applications, Dr. Robert G. Harris observed that Pacific Bell's investment in a hybrid fiber-coax architecture should result in substantial savings in operations and maintenance costs for its

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[41/] See, e.g., Economics and Technology, Inc., "Commercially Feasible Resale of Local Telecommunications Service," at 13 n.11, 17 n. 16 (1995).

[42/] Id.

traditional telephony operations.[43] While CCTA has questioned the validity of Dr. Harris's assumptions, it is nonetheless appropriate for the Commission to hold Pacific Bell and other LECs accountable for such asserted cost savings when establishing an X-Factor for the price cap index.

Third, the Christensen Associates study understates expected LEC productivity growth because it understates the actual productivity growth that the LECs have historically achieved. This is most tellingly demonstrated in the reports attached to the comments of Ad Hoc Telecommunications Users Committee ("Ad Hoc")[44] and AT&T.[45] Experts for both parties, including internationally known TFP experts Dr. Ernst Berndt and Dr. John Norsworthy, critiqued the earlier version of the Christensen Associates study on many grounds. Although some of their criticisms have been addressed in the new Christensen Associates study, that study perpetuates two of the major flaws that Ad Hoc and AT&T pointed out with respect to the earlier study. The Christensen Associates study fails to incorporate the price differential between the inputs used by LECs and those used by the economy as a whole and, more specifically, fails to take into account improvements in the quality of the inputs used to provide telecommunications services, thus overstating their cost.

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[43] See Applications of Pacific Bell, Robert G. Harris, Testimony in Support of Pacific Bell's Section 214 Applications for Video Dialtone Service, File Nos. W-P-C 6913-6916, Exhibit 3 at 8 (filed Dec. 20, 1993).

[44] See Ad Hoc Comments, Attachment, Economics and Technology, Inc., "Establishing the X-Factor for the FCC Long-Term LEC Price Cap Plan" (filed Jan. 16, 1996) ("ETI Report") .

[45] See AT&T Comments, Appendix A, Statement of Dr. John R. Norsworthy, "Analysis of TFP Methods for Measuring the X-Factor of the Local Exchange Carriers' Interstate Access Services" (filed Jan. 11, 1996).

The combined effect of these two errors is a significant understatement of achieved LEC productivity.

C. The Evidence Supports A Finding By the Commission that the Input Price Differential Should Be Retained and Increased

In its LEC Price Cap Order, the Commission found persuasive evidence to indicate that the price of the inputs that LECs use has grown more slowly than has the price of the inputs used in the economy as a whole.[46] Because this "input price differential" adds significantly to the calculated X-Factor, the LECs have vigorously attacked the Commission's conclusion in their opening comments.[47] Ironically, the LEC comments — taken together with evidence provided by consultants to Ad Hoc and AT&T — provide a sound basis for the Commission to retain and even to increase its estimate of the input price differential.

For example, GTE acknowledges that economic theory requires the Commission to consider both the difference between LEC and economy-wide productivity growth and the difference between LEC and economy-wide input price growth.[48] GTE goes on to argue that, as a matter of both theory and empirical evidence, the input price differential is zero, i.e., the rate of growth for LEC input prices is identical to the rate of growth for input prices for the economy as a whole.[49] In advancing this argument, GTE, like USTA, asserts that

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[46] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, 5 FCC Rcd 6786, 6796 (1990) ("LEC Price Cap Order"); recon., 6 FCC Rcd 2637 (1991), aff'd sub nom., National Rural Telephone Ass'n v. FCC, 988 F.2d 174 (D.C. Cir. 1993).

[47] See USTA Comments at 25-27; GTE Comments at 6-15; Pacific Comments at 2-6; SWBT Comments at 11-12.

[48] GTE Comments at 7.

[49] Id. at 11.

the Commission based its non-zero input price differential on improper statistical evidence.[50] Specifically, both GTE and USTA claim that the Commission should have tested the "null hypothesis" that there is no difference between the rate of growth of LEC input prices and the rate of growth of input prices in general "because economic theory suggests that the two series move together."[51]

The problem with this argument is that economic theory suggests no such thing. Instead, because LECs are much more capital-intensive than the economy as a whole and because LECs are much more heavily dependent on inputs such as electronic switches and fiber-optic cable that are subject to declining real costs, economic theory suggests that LEC input prices should grow at a different (lower) rate than do input prices in the economy as a whole.[52]

In fact, if anything, the Commission should increase the input price differential that it incorporates into the price cap index in its First Report and Order to take into account "hedonic price changes" (i.e., changes in the quality of products and services that affect their relative price) in LEC inputs.[53] The dramatic quality improvements in digital switching and fiber-optic transmission media that have occurred and are continuing to occur are not reflected in the Christensen Associates data used to calculate USTA's simplified TFP

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[50] Id. at 12.

[51] Id. at 12; see also USTA Comments at 11.

[52] See Ad Hoc Comments, ETI Report at 35.

[53] The rationale for including hedonic price changes in the measurement of TFP is thoroughly discussed in the report accompanying Ad Hoc's comments, and CCTA will not reiterate that discussion here. Id. at 36-42.

measure. The statement by Dr. Norsworthy attached to AT&T's comments illustrates the significance of failure to incorporate quality changes in the telephone plant index.[54/] For example, use of a quality-adjusted index for electronic switching costs produced a 36% decline in input prices between 1982 and 1985, whereas a similar telephone plant index that was not adjusted for quality produced only a 7% decline in price during the same period.[55/] As this example illustrates, quality improvements in inputs can greatly lower their effective cost. Economics and Technology, Inc. conservatively estimates that inclusion of the effect of quality improvements in LEC inputs would add an additional 40 basis points to the estimated LEC TFP.[56/]

II. THE COMMISSION SHOULD NOT MAKE FUNDAMENTAL ADJUSTMENTS TO THE PRICE CAPS REGIME PRIOR TO IMPLEMENTING RELEVANT PORTIONS OF THE TELECOMMUNICATIONS ACT OF 1996

Although the Commission issued the Fourth NPRM in an attempt to develop a long-term method for setting the X-Factor, it did so in full recognition that its policy goals for LEC price cap revisions are, by necessity, dependent upon "the purposes and provisions of the Communications Act."[57/] In this regard, the Commission specifically referenced the

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[54/] AT&T Comments, Appendix A, Statement of Dr. John R. Norsworthy, "Analysis of TFP Methods for Measuring the X-Factor of the Local Exchange Carriers' Interstate Access Services," at 49-58.

[55/] Id. at 55.

[56/] See Ad Hoc Comments, ETI Report at 57.

[57/] See First Report and Order, 10 FCC Rcd at 9002-03.

impact that price cap revisions may have on its critical universal service goals.[58]

As the Commission is well aware, the 1996 Act, which became law just three weeks ago, directs sweeping changes to fundamental aspects of the regulatory treatment of LECs, including to the critical universal service area.[59] The overarching thrust of the law is to foster open competition that will replace regulation where possible, including price regulation of the LECs' rates.[60]

CCTA asserts that in light of the impending regulatory changes that the Commission will undertake as a result of the 1996 Act and the changes that were instituted to the price cap scheme less than one year ago, the Commission would be ill advised to adopt major revisions to the price cap scheme at this juncture. Instead, if anything, the Commission should fine-tune its price cap formula by adjusting the X-Factor upward to account for more complete information regarding the input price adjustment and new information regarding the LECs' opportunities for entering new markets. Other than this fine-tuning, however, the Commission should leave the current price cap regime untouched until after it has issued regulations implementing the 1996 Act and had an opportunity to gauge the effect of the 1996 Act on LEC productivity and performance.

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[58] Id. ("For example, any revisions we adopt may require analysis of their effect on another primary goal, universal service, as set out in Section 1 of the Act and as implemented in various current Commission programs.").

[59] See 47 U.S.C. § 254, as enacted by Pub. L. No. 104-104, §101(a), 110 Stat. 56 (1996).

[60] Conference Report at 113, 184-185.

As an example, consider the LECs' positions here, and in the Second Further Notice of Proposed Rulemaking, regarding pricing flexibility.[61] In response to the Fourth NPRM, USTA argues that the Commission should not tie the level of the X-Factor to the authorization of increased pricing flexibility, because it believes all carriers should be afforded increased pricing flexibility immediately (including, presumably, the ability to offer switched access services under contract), whereas some carriers cannot "afford" to accept a higher X-Factor.[62] Given the many barriers to effective facilities-based local competition that remain today,[63] it is completely inappropriate to grant the LECs increased pricing flexibility[64] before the Commission acts decisively to implement the pro-competitive

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[61] See generally Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, FCC 95-393, Second Further Notice of Proposed Rulemaking ("Second FNPRM"), USTA Second FNPRM Comments (filed Dec. 11, 1995); SNET Second FNPRM Comments at 8-22; GTE Second FNPRM Comments 3-37, 46-77.

[62] USTA Comments at 43-44.

[63] CCTA Second FNPRM Comments at 6-10.

[64] Specifically, CCTA urges the Commission to reject the proposal to permit LECs to offer, at their option, services on a contract tariff basis. See, e.g., Pacific Bell Second FNPRM Comments at 12; Bell South Second FNPRM Comments at 55-58; GTE Second FNPRM Comments at 18-21. Failure to do so will harm incipient local telephone services competition and frustrate the articulated goals of the Telecommunications Act. See e.g., 47 U.S.C. (Part II entitled "Development of Competitive Markets") §§ 253, 256, 257, 259, as enacted by Pub. L. No. 104-104, § 101; 110 Stat. 56 (1996), Conference Report at 135, 136. In this regard, CCTA agrees fully with AT&T that the LECs' "near total power in the existing access market [provides] no basis to afford them relief prior to the time they face sufficient competition to be eligible for streamlining generally." AT&T Corp. Second FNPRM Comments at 49. Significantly, the Commission has already held that contract tariffs are only appropriate for services that are "substantially competitive," see Expanded Interconnection with Local Telephone Company Facilities, CC Docket No. 91-141, Transport Phase II, 9 FCC Rcd. 2718, 2731 n.174 (1994), and that emerging competition for switched access services does not justify contract carriage authority for the LECs. See Southwestern Bell Tel. Co. Tariff F.C.C. No. 73, Transmittal Nos. 2433 and 2449, CC Docket No. 95-140, FCC 95-476, Order Terminating Investigation (released November 29, 1995).

provisions of the 1996 Act.

Critically, the 1996 Act itself reveals that it is clearly premature for the Commission to attempt to resolve many of the issues raised in its rulemaking. For example, in this proceeding, the FCC has sought comment on the impact of various state and federal universal service programs on the LECs' productivity, including calculations of the X-Factor.[65/] Given the statutorily mandated resolution of some key universal service issues by November 1996, and others by May, 1997,[66/] it would be imprudent for the Commission to proceed generally in the price caps context when it has accurately acknowledged the interplay of these issues.[67/]

In arguing for the Commission to retain the current price caps framework virtually intact at this time, CCTA does not mean to imply that the current framework is perfect. The Commission can and should make changes to the price caps framework after it implements the provisions of the 1996 Act which are intended to foster a truly competitive marketplace. As the Commission has repeatedly recognized, and as CCTA agrees, it is effective facilities-

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[65/] Fourth NPRM at ¶¶ 71-72.

[66/] See Common Carrier Bureau Public Form on Implementing the Telecommunications Act or 1996, Implementation Schedule at 1-2 (Feb. 23, 1996).

[67/] Significantly, in the CPUC proceeding regarding universal service costs, there has been substantial disagreement regarding the relevant costs. See Informational Hearing: The Telecommunications Act of 1996, California Legislature, Senate Committee on Energy, Utilities and Communications, February 27, 1996, "Communications Competition" (estimated costs of universal service in California range from $50 million to $1.4 billion).

based competition that holds the best prospect for fair rates, terms and practices.[68] Despite the shortcomings that may exist in today's regulatory models, however, the risks of constant change to the price caps regime, especially in the face of the wide-ranging changes necessitated by the 1996 Act, and the uncertainty and opportunities for manipulation they will engender, outweigh the drawbacks of the current price caps mechanism. Given the Commission's overarching goal of promoting genuine facilities-based competition, CCTA asserts that the Commission should focus its time and energy on promoting effective competition, not on revisions to the price caps framework that will only need to be revisited once the 1996 Act is implemented.

III. THE USE OF PRICE CAP REGULATION WILL NOT BY ITSELF ENSURE THAT RATES ARE DRIVEN TO ECONOMIC COST

As CCTA has observed in its previous filings in this docket,[69] proceedings regarding Pacific Bell's and GTE's Section 214 applications for authority to offer video

[68] Indeed, the FCC has repeatedly asserted that its policy goals are best achieved by "actual competition," although it has recognized that this is far from the present reality. Cite. Thus, the Commission stated: "With prices set by marketplace forces, the more efficient firms will earn above-average profits, while less efficient firms will earn lower profits, or cease operating." First Report and Order, 10 FCC Rcd. at 9002. See also CCTA Second FNPRM Comments at 13-15.

[69] See, e.g., Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, CCTA Comments (filed May 9, 1994), CCTA Reply Comments (filed June 29, 1994); Price Cap Performance Review for Local Exchange Carriers, Treatment of Video Dialtone Service Under Price Cap Regulation, CC Docket No. 94-1, CCTA Comments at 12-14 (filed April 17, 1995), CCTA Reply Comments at 16-19 (filed May 17, 1995).

dialtone services,[70] and general video rulemaking proceedings,[71] neither the FCC's price cap framework, nor California's intrastate price cap framework,[72] precludes either GTE or Pacific Bell from subsidizing the deployment of competitive video services -- such as cable, video dialtone, or open video systems[73] -- through artificially inflated price cap rates for regulated telephone services. To protect against this cross-subsidy, price cap rates would need to be divorced fully from the costs of deploying such services. Under the FCC's proposed price cap framework, however, price cap LEC costs directly impact the X-Factor,

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[70] See Applications of Pacific Bell for Authority Pursuant to Section 214 of the Communications Act, as Amended, to Construct, Operate, Own, and Maintain Advanced Fiber Optic Facilities and Equipment to Provide Video Dialtone Service to Selected Communities in Orange County, the Southern San Francisco Bay area, the Los Angeles area, and the San Diego area in California, File Nos. W-P-C 6913-6916, CCTA Petition to Deny (filed Feb. 9, 1994). See Contel of Virginia, Inc., doing business as GTE Virginia, et al., File Nos. W-P-C 6955-6958, CCTA Petition to Deny GTE's California Application (filed July 5, 1994).

[71] See In the Matter of Telephone Company-Cable Television Cross-Ownership Rules, Sections 63.54-63.58, CC Docket No. 87-266, CCTA's Supplemental Reply Comments on the Fourth Further Notice of Proposed Rulemaking, at 11-12 (filed May 4, 1995).

[72] See Pacific Bell, 153 PUR 4th 65, 68-69 (CPUC 1994). As more fully described in CCTA's Supplemental Reply Comments in Docket No. 87-266, the California state price-cap mechanism is deficient due to a low productivity offset that does not reflect the true efficiencies being realized by the LECs; an overly generous exogenous cost adjustment that allows the LECs to unfairly shift a large amount of its business risks to their ratepayers; and an interim earnings-sharing mechanism that encourages the LECs to reduce profits through inefficient spending.

[73] See 47 U.S.C. § 653, as enacted by Pub. L. No. 104-104, § 302(a), 110 Stat. 56 (1996).